Financial Markets

9/20/83

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Irving Trust

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Economic Research &
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(Noon)

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My last "Financial Markets" letter was a bit more prophetic than I might have hoped: We have had a great deal of market volatility. M1 fell by $2.0 billion last Friday, much more than the market had expected--bringing M1 to the bottom of its growth range--and so the bond market rallied sharply. Then, a rumor that this decline would be revised away stemmed the bond market rally, led the dollar to recoup its sharp losses in the foreign exchange markets, and sent the stock market down. Subsequently, the widespread conviction that today's (Sept. 16) money supply number will be up sharply has backed up bond yields much more. We indeed are experiencing much more volatility in the major financial markets: money, stock, and foreign exchange.

Whatever the Fed might say, these markets are very much looking at M1. The very notion that the stock market might decline on the basis of rumors of an M1 revision indicates the vulnerability and focus of that market. As for the bond and foreign exchange markets, these are plugged into the Fed's own reaction function. So far this year many analysts believe the Fed has been reacting more to M1's excessive growth spurts than to any other single factor. So can you blame the markets?

If there is something to blame, it's the Fed's resetting of a new M1 growth range at mid-year. While the FOMC realized that this new range might be misinterpreted by the market, the new range was adopted anyway. The market has chosen to watch M1's growth with a microscope only because the Fed has consistently seemed to react to it this year. Were the Fed to ignore M1, so would the markets. But the Fed has not, so the markets now see the possibility of M1 moving from the bottom to the top of its growth range (in one week!) and they have reacted accordingly.

Unfortunately for the markets, it appears that the Fed really has changed its emphasis. The economy seems to be at the center of the Fed's policy objectives even though money growth remains important. And the lesson of the past three years is that high interest rates don't stop this economy quickly. Indeed, very high interest rates are required. As a result the Fed will be looking at the most interest-sensitive sectors: housing and autos. Signs of true weakness here will lead the Fed to back off because it wishes the recovery to continue. The Fed will lower rates long before the economy posts declines in real income. Thus, it is this much more eclectic policy that puts M1's velocity in the limelight.

I do not contend that M1 growth is irrelevant and that market reactions are "wrong." Rather, M1 is important when its growth is clearly excessive: at the top, or over the top, of its growth range. In other circumstances the economy, or put differently, M1's velocity, is important. Thus M1 has an asymmetric importance. The markets clearly appreciate that, if M1 rises, interest rates will rise too. However, they seem not to grasp (yet) that a weaker growth of M1 will take some time before it will translate to a policy of easing by the Fed. So let's expect lower interest rates but let's not get overanxious.

Robert A. Brusca

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Market Yields

	9/16/83 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	11.00%	11.00%	13.50%
Effective since	8/8/83		
Discount Rate at Federal Reserve Bank	8.50	8.50	10.00
Federal Funds	9.63	9.63	10.25
Repurchase Agreements	9.60	9.50	8.50
U.S. Treasury Issues			
Bills			
3 months	9.40	9.42	8.24
6 months	9.81	9.91	10.10
1 year	10.19	10.31	11.09
Coupons			
2 years	10.91	10.87	12.03
4 years	11.36	11.39	12.57
7 years	11.67	11.68	12.71
10 years	11.73	11.71	12.54
Long Bond	11.76	11.71	12.13
Negotiable Certificates of Deposit-Secondary Market			
1 month	9 40	9.40	10.55
3 months	9.50	9.50	10.95
6 months	9.75	9.80	11.70
1 year	10.35	10.25	12.00
Banker's Acceptances			
1 month	9.42	9.35	11.50
3 months	9.55	9.60	11.13
6 months	9.86	9.85	12.25
Eurodollar Deposits			
1 month	9.94	9.88	10.40
2 months	10.00	10.00	10.90
3 months	10.00	10.13	11.65
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	9.65	9.40	9.53
1 month	9.59	9.45	10.10
3 months	9.60	9.74	10.67
Bank Holding Companies			
1 month	9.19	9.19	10.62
Dealer Placed:			
3 months	9.73	9.70	10.67
New AA Corporate Utility Bond	13.00	12.90	14.45
Tax Exempt			
6 month Project Notes	5.65	5.60	5.40
1 year AAA Bond	5.50	6.00	6.75
5 year AAA Bond	6.70	7.10	8.00
20 year AAA Bond	9.35	9.30	10.10

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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